91-1806

No. 91-___

Supreme Court, U.S.
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In The

Supreme Court of the United States

October Term, 1991

ALLIED MUTUAL INSURANCE COMPANY,

Petitioner,

vs.

NORTHERN INSURANCE CO. OF NEW YORK,

Respondent.

Petition For Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

PETITION FOR WRIT OF CERTIORARI OF ALLIED MUTUAL INSURANCE COMPANY

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May 5, 1992

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QUESTIONS PRESENTED

1. Where a lawsuit accrued in Washington and was filed in a Washington court by Washington plaintiffs against a Tennessee defendant and defended under a reservation of rights by a Washington attorney under an insurance contract issued by an Iowa insurance company ("Allied"), should California law apply to govern the ethical obligations of the Washington defense attorney where California only has an interest in the lawsuit because the insurance contract was executed in California and was assigned by operation of law from a California insured to the Tennessee defendant, and would application of California law be arbitrary and fundamentally unfair so as to constitute a deprivation of property without due process of law?

2. May an insurance contract be assigned by operation of law upon the sale of an insured's assets where (i) the insured does not assign the insurance contract but retains benefits under the contract for its own protection, (ii) the insurance contract contains a clear and unambiguous anti-assignment provision requiring the written consent of the insurer to any assignment, and (iii) the insurance company does not consent to any assignment of the insurance contract?

LIST OF PARTIES

Northern Insurance Co. of New York ("Northern") was the Plaintiff below and is the Respondent before this Court.

Allied Mutual Insurance Company ("Allied") was the Defendant below and is the Petitioner before this Court. Allied owns stock in and has a joint pooling agreement with ALLIED Group Inc., which is a holding company.

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No. 91-___

In The

Supreme Court of the United States

October Term, 1991

ALLIED MUTUAL INSURANCE COMPANY,

Petitioner,

vs.

NORTHERN INSURANCE CO. OF NEW YORK,

Respondent.

Petition For Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

PETITION OF ALLIED MUTUAL INSURANCE COMPANY

Petitioner Allied Mutual Insurance Company ("Allied") respectfully prays that a Writ of Certiorari issue to review the decision and Judgment of the United States Court of Appeals for the Ninth Circuit filed on February 7, 1992.

OPINIONS BELOW

The Opinion of the Court of Appeals is included in Appendix A. The unpublished opinions (Orders) of the United States District Court for the Western District of

Washington (Coughenour, D.J.) ("the District Court") are included in Appendices B and C.

JURISDICTION

The Opinion and Judgment of the Court of Appeals were filed on February 7, 1992. Petitioner's Motion to Stay Issuance of the Mandate was denied by Order filed March 4, 1992, and the Mandate issued on that date. Jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

RELEVANT CONSTITUTIONAL PROVISIONS, STATUTES AND COURT RULES

The pertinent constitutional provisions, statutes and court rules are set forth in Appendices D-F.

STATEMENT OF THE CASE

Factual Background

Allied and Respondent Northern Insurance Co. of New York ("Northern") issued comprehensive general liability insurance contracts insuring California Cooler, Inc. ("Old CCI") in consecutive time periods between April 1983 and September 1985. Two years after Allied's insurance contract expired, Brown-Forman Corporation ("BFC") (a Tennessee corporation with its principal place of business in Kentucky) purchased most of Old CCI's assets, but not Allied's expired insurance contract. BFC

did not assume liability for any product liability claims arising from Old CCI's pre-sale activities, and Old CCI contracted to indemnify BFC for such claims. BFC then formed a new company having the name "California Cooler, Inc." ("New CCI").

After Old CCI sold its assets to BFC, a lawsuit ("the *Howard* lawsuit") was filed in the United States District Court for the Western District of Washington in which the plaintiffs in that lawsuit sought damages for their child's birth defects that allegedly resulted from the mother's consumption, during her pregnancy, of alcohol, including wine coolers manufactured before the asset sale by Old CCI. BFC and New CCI were served with that lawsuit, but Old CCI, although named, was never served.

BFC hired the Seattle law firm of Preston, Thorgrimson, Holman & Ellis (the "Preston law firm") and tendered the *Howard* lawsuit defense to Northern. Northern hired a different Seattle firm to defend BFC because the hourly billing rates for the Preston law firm were much higher than those typically charged for such a defense. After BFC agreed to pay a part of the fees, Northern acceded to BFC's demand that it be represented by the Preston law firm. The Preston law firm defended only BFC and New CCI and did not provide a defense to Old CCI.

After learning that Allied had insured Old CCI, Northern notified Allied of the *Howard* lawsuit. BFC eventually tendered defense of the *Howard* lawsuit to Allied, and Allied accepted BFC's tender under a reservation of rights. Allied hired the Seattle law firm of Betts, Patterson & Mines ("the Betts law firm") to defend BFC.

Although it initially objected, BFC later agreed to representation by the Betts law firm. The *Howard* lawsuit eventually was voluntarily dismissed, and the plaintiffs in that lawsuit did not recover for their alleged damages.

Proceedings in the District Court

Northern filed a lawsuit in the District Court (based on diversity jurisdiction) against Allied seeking equitable contribution from Allied for the defense costs incurred by BFC and New CCI in the *Howard* lawsuit. In its Motion for Summary Judgment, Allied contended that it had no duty to defend BFC and New CCI because Old CCI had not assigned the insurance contract to BFC and the contract could not be assigned without Allied's consent; that even if the insurance contract could be assigned, the duty to defend could not be assigned; and that, even if that duty could be assigned, Washington law governed whether Allied had fulfilled any duty to defend by hiring the Betts law firm to conduct the defense. The District Court denied Allied's Motion and ruled in pertinent part:

1. Even though Old CCI had not assigned the insurance contract to BFC, the contract, including the duty to defend, transferred to BFC as a matter of law because liability for Old CCI's pre-sale activities could have transferred to BFC as a matter of law under a successor liability tort theory.

2. California law governed the determination of whether Allied discharged its duty to defend by hiring the Betts law firm.

Proceedings Before the Court of Appeals

Both Allied and Northern appealed to the United States Court of Appeals for the Ninth Circuit. In its brief filed in the Court of Appeals, Allied again contended that the duty to defend could not be assigned by operation of law and that Old CCI had not assigned the insurance contract in fact, and that, even if the duty to defend could be assigned, under Washington law Allied had fulfilled any duty to defend BFC by hiring the Betts law firm.

On February 7, 1992, the Court of Appeals issued its Opinion affirming in relevant part the District Court's rulings. The Court of Appeals agreed with the District Court that neither Old CCI nor BFC intended for there to be an assignment and that *in fact* Old CCI did not assign Allied's insurance contract to BFC. The Court nevertheless held that the policy benefits, including the right to a defense from Allied, transferred by *operation of law* to BFC when it purchased Old CCI's assets. The Court further held that California law applies to the determination of whether Allied performed its duty to defend and that, under California law, Allied failed to meet its obligation to provide a defense by hiring the Betts law firm.

Allied filed a timely Motion for stay of issuance of the appellate court mandate on the ground that Allied was preparing to file this Petition for Writ of Certiorari. The Court of Appeals denied Allied's Motion on March 4, 1992 and issued the Mandate on that date.

REASONS FOR GRANTING THE WRIT

I.

The decision of the Court of Appeals that applies California law to the ethical duties owed by a Washington attorney in a Washington court conflicts with decisions of this Court and deprived Allied of a property interest without due process of law.

The decision of the Court of Appeals conflicts with decisions of this Court in that the Court of Appeals impermissibly applied California law when that state had no significant interest in the litigation. In applying California law, the Court deprived Allied of a property interest without due process of law in violation of the Fourteenth Amendment.

The California and Washington Supreme Courts have construed their state's rules regarding an attorney's ethical duties when an insurer is defending its insured under a reservation of rights and have set forth conflicting standards of conduct. The California Supreme Court ruled that California's Ethical Canons require the insurer to pay for independent counsel selected by the insured if the insured does not consent to joint representation of the insured and insurer by common counsel. *San Diego Navy Fed. Credit U. v. Cumis Ins.*, 162 Cal. App. 3d 358, 208 Cal. Rptr. 494, 506 (1984). The rule in *Cumis* was modified by the California legislature and codified in California Civil Code § 2860 (1987). *Center Foundation v. Chicago Ins. Co.*, 227 Cal. App. 3d 547, 278 Cal. Rptr. 13, 19-20 n. 8 (1991). The Washington Supreme Court, interpreting Rules of Professional Conduct virtually identical to California's Ethical Canons examined in *Cumis*, ruled that those Rules

allow the insurer to choose the attorney, who must keep both the insured and insurer fully informed. *Tank v. State Farm Fire & Cas. Co.*, 105 Wash. 2d 381, 715 P.2d 1133, 1137-38 (1986). Washington courts have refused to apply *Cumis* when given the opportunity to choose between the conflicting decisions in *Tank* and *Cumis*. *Johnson v. Continental Cas. Co.*, 57 Wash. App. 359, 788 P.2d 598, 600 (1990).

If Washington law applies to this matter, as it should, Allied fulfilled any duty it owed to provide a defense to BFC in hiring the Betts law firm to defend BFC. On the other hand, if, as the Court of Appeals ruled, California law applies, Allied arguably did not fulfill its duty under California Civil Code § 2860. Contrary to Washington choice-of-law rules, and in violation of the Due Process Clause of the Fourteenth Amendment, the Court of Appeals applied California law to determine whether Allied had a duty to provide a defense to BFC and whether Allied fulfilled that duty. Application of California law was arbitrary and capricious because California had no interest in the *Howard* lawsuit.

The Fourteenth Amendment's Due Process Clause places constitutional limits upon choice-of-law decisions.[1]

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[1] While Allied did not expressly contend below that its Due Process rights would be violated if California law is applied, Allied did contend that the state with the most significant relationship to the *Howard* lawsuit should apply its laws. That contention essentially is identical to this Due Process argument. Whether one phrases the issue in terms of "Due Process" or the "most significant relationship" test in a choice-of-law determination, the issue presented is whether the particular state has a sufficient relationship to the parties and the transaction to make application of that state's law appropriate.

Application of the law of a state having no interest in the litigation is so unconstitutionally arbitrary and fundamentally unfair that it constitutes a taking of property without due process of law. *Allstate Ins. Co. v. Hague*, 449 U.S. 302, 308, 101 S. Ct. 633, 66 L. Ed. 2d 521 (1981); *Home Ins. Co. v. Dick*, 281 U.S. 397, 407-08, 50 S. Ct. 338, 74 L. Ed. 926 (1930). Additionally, courts sitting in diversity must apply the conflict-of-law rules of the forum state. *Klaxon Co. v. Stentor Electric Mfg. Co.*, 313 U.S. 487, 496, 61 S. Ct. 1020, 85 L. Ed. 1477 (1941).

Washington has adopted the "most significant relationship" test, as set forth in *Restatement (Second) Conflict of Laws* (1971) ("Restatement"), as its rule governing choice of law questions with respect to insurance contracts. *Dairyland Ins. v. State Farm Mut. Auto. Ins.*, 41 Wash. App. 26, 701 P.2d 806, 808-09 (1985). The Restatement acknowledges the constitutional requisite that the state whose law is applied must have significant contacts with the parties and the litigation.

Under the Restatement rule, Washington courts examine a number of factors indicating the interest a state would have in the application of its laws to the particular issue and apply the law of the state having the "most significant relationship" to the transaction and the parties. Restatement § 188. Washington courts will not apply the law of another state, even if that state has some interest in having its law applied, if application of that state's law would not advance that law's purpose. *Mentry v. Smith*, 18 Wash. App. 668, 571 P.2d 589, 591 (1978); Restatement § 6. Applying that rule to this matter, Washington has the most significant relationship to the defense of the *Howard* lawsuit, and the purpose of California's

Cumis rule of law would not be furthered by its application to this matter.

If, as the Court of Appeals erroneously ruled, the insurance contract was assigned by operation of law (see Section II below), California no longer had an interest in any issue pertaining to that insurance contract because BFC is not a California insured and is instead a Tennessee corporation having its principal place of business in Kentucky. The purpose of the California *Cumis* statute, as stated by the Court of Appeals – protection of California insureds – is not fulfilled by application of that California law to this matter because the defense of the *Howard* lawsuit was not provided to a California insured. Consequently, Washington's law should have applied to this matter.

Washington has the most significant relationship to the parties and the transaction giving rise to the *Howard* lawsuit because the defense of that lawsuit was provided by Washington attorneys in an action filed by Washington plaintiffs in a Washington court. A federal district court in Washington has the primary responsibility for controlling the ethical conduct of the attorneys practicing before it. *Kaiser Steel Corp. v. Frank Coluccio Const. Co.*, 785 F.2d 656, 658 (9th Cir. 1986); Local Rules, U.S. Dist. Ct. (W.D. Wash.), G.R. 2(e)(1). Because attorneys are essential to the proper administration of justice, a state has a compelling interest in regulation of the practice of law within its own borders. *See, e.g., Sperry v. Florida*, 373 U.S. 379, 382-83, 83 S. Ct. 1322, 10 L. Ed. 2d 428 (1963); *see also Middlesex Ethics Comm. v. Garden State Bar Assn.*, 457 U.S. 423, 432-33, 102 S. Ct. 2515, 73 L. Ed. 2d 116 (1982).

Moreover, one of the factors that a Washington court is required to examine in making its choice-of-law determination is the location of the subject matter of the contract. Restatement § 188(2)(d). That factor is of the utmost importance with respect to liability insurance contracts. Restatement § 193 provides that the rights created by liability insurance contracts are to be determined by the local law of the state that was the principal location of the insured risk. Specifically, the law of the state where the insured risk is located governed the precise question before the Court of Appeals in this matter – "whether in the case of liability insurance the insured can recover from the company the cost of defending an action involving a risk covered by the policy." Restatement § 193, comment a.

Where, as here, the insurance contract covers risks in several states, the court is to treat the case as if it involved separate contracts issued in each state where a risk is located and apply the law of the individual state that is the location of the insured risk giving rise to the litigation. *Id.* at comment f. Washington's choice-of-law rules required the Court of Appeals to treat Allied's insurance contract as if it were a separate contract in each state where Old CCI (the insured) sold its wine coolers and to apply Washington law to determine the right to recover the costs of defense of a lawsuit filed in Washington.

Allied reasonably expected that Washington law would apply in such an instance and conducted its defense of the *Howard* lawsuit accordingly. In *Tank, supra,*

the Washington Supreme Court set forth Washington policy regarding protection of insureds and the ethical conduct of attorneys representing both insurers and insureds in a reservation-of-rights defense. The application by the Court of Appeals of the California *Cumis* rule to determine whether Allied fulfilled its obligations in that regard simply cannot be reconciled with that policy.

The decision of the Court of Appeals goes to the very heart of a state's rights, retained under the Tenth Amendment, to control the administration of justice in its own courts. If not reversed, the decision of the Court of Appeals applying California law would be precedent to remove a state's control of an attorney's ethical conduct in that state where an insured is being defended simply on the basis that the insurance contract was issued in another state. That means that attorneys in a state that has the most significant relationship to the lawsuit in question would be governed by another state's rules prescribing the ethical conduct of that state's attorneys even though neither the attorneys, the insured defendants nor the plaintiffs had any contact with that state other than the fact that the insurance contract was issued there.

While California has the power to legislate regarding the ethical conduct of attorneys representing insureds and insurers in California and has the power to provide rules for protecting the interests of California insureds, the California legislature cannot project its laws across state lines to prevent Washington courts from determining the legal consequences of an attorney's representation of both an insurer and insured in Washington. That especially is true when the California law is contrary to the stated policy of Washington and when the purpose of the

California law would not be furthered by application of that law in Washington. *See Pacific E. Ins. Co. v. Industrial Acci. Com.*, 306 U.S. 493, 504-05, 59 S. Ct. 629, 83 L. Ed. 940 (1939).

In this matter, Washington was the location of the insured risk and the state with the "most significant relationship" to the *Howard* lawsuit in which the defense was provided. Washington's law should have been applied to determine whether Northern could recover the costs of defense in an action so affecting the administration of justice in a Washington court. California had no interest in the litigation. Despite this Court's clear guidance, the Court of Appeals applied the law of California even though that state had no significant contact with either the parties to the *Howard* lawsuit or the occurrence giving rise to that litigation.

The decision of the Court of Appeals is in conflict with relevant decisions of this Court. Only this Court can provide guidance to courts regarding the permissible limit of the application of the laws of one state to govern ethical obligations of attorneys in another state under circumstances as those in this matter. Accordingly, this Petition for Writ of Certiorari should be granted.

II.

This Court needs to resolve the conflict between the circuits of whether insurance contracts can be assigned by operation of law.

The Court of Appeals correctly ruled that Old CCI did not assign Allied's insurance contract to BFC when Old CCI sold its assets to BFC. However, the Court ruled

that, by that sale of assets, the insurance contract was assigned to BFC *by operation of law* because liability could have transferred to BFC under a successor liability tort theory. That ruling ignores the clear meaning of the insurance contract (which contains an anti-assignment provision requiring the written consent of Allied to any assignment), it conflicts with decisions of other courts of appeals, and it requires review by this Court given its importance to insurance law in general. Never before has a court ruled that an insurance contract can be assigned by operation of law by a sale of assets when neither the insured nor the insurer have consented to that assignment and the contract expressly provides otherwise.

The Court of Appeals based its decision on a case – *Ocean Accident & Guar. Corp. v. Southwestern B. Tel. Co.*, 100 F.2d 441 (8th Cir.), *cert. denied*, 306 U.S. 658, 59 S. Ct. 775, 83 L. Ed. 1056 (1939) – holding that, once a loss has occurred, the insured's rights under the insurance contract are a debt or "chose in action" that may be assigned even if the contract contained a provision prohibiting assignment without consent of the insurer. In such instances, the insured is not assigning the contract but is assigning the debt. In *Ocean Accident*, the insured actually executed an assignment of the insurance contract to the purchaser of the debt owed by the insurer.

Except for the Court in this matter, no court has held that an insurance contract is assigned upon a sale of assets even though the insured specifically does not execute an assignment of the contract. In fact, the rule followed in other circuits and in Washington and California is that a simple sale of assets covered by the insurance contract does *not* transfer the benefits of the contract

unless the insured makes an express assignment of those rights with the insurer's consent, particularly where the insurance contract requires that consent. *See, e.g., Byrd v. American Guarantee and Liability Ins. Co.*, 180 F.2d 246, 248-49 (4th Cir. 1950); *Newark Fire Ins. Co. v. Turk*, 6 F.2d 533, 534 (3d Cir. 1925); *Alexander v. Security-First Nat. Bank of Los Angeles*, 7 Cal. 2d 718, 62 P.2d 735, 737 (1936); *Davis v. Oregon Mutual Insurance Company*, 71 Wash. 2d 579, 429 P.2d 886, 887 (1967); 1 George J. Couch, LL.B, *Cyclopedia of Insurance Law* § 1.7 (2d ed. 1984).

In a case quite similar to this matter – *Independent Petrochem. Corp. v. Aetna Cas. & Sur.*, 654 F. Supp. 1334, 1347 (D. D.C. 1986), *aff'd sub nom, Indept. Petrochemical v. Aetna Cas. & Sur. Co.*, 944 F.2d 940 (D.C. Cir. 1991) – Signal sold its insured subsidiary, Independent Petrochemical Corporation ("IPC"), to Charter. The purchase agreement required Signal to make its best effort to continue the insurance after the sale if Charter requested it. 944 F.2d at 948. Charter did not request assignment of the insurance contract and did not pay premiums to the insurance company. 654 F. Supp. at 1348. After it was sued, IPC claimed that it was still an insured under the Signal insurance contract because the insurance company did not delete IPC as a named insured at the time of the sale. The insurance company argued that, because Signal never made an assignment and the insurance company never gave its consent to an assignment, the insurance did not continue after the sale. *Id.* The district court ruled that a written assignment of the insurance contract was necessary to transfer the contract as part of IPC's capital stock. *Id.* at 1349. The Court of Appeals affirmed and ruled that continued insurance coverage was not an

"automatic consequence" of the sale and that Charter took none of the steps necessary to obtain an assignment of the policy. 944 F.2d at 948.

The decision of the Court of Appeals in this matter conflicts with decisions of other circuits. Moreover, it creates confusion regarding the rights of insurance companies and their insureds when the insured sells its assets but does not assign the insurance contract. Consequently, this matter is of obvious importance to all insurers issuing liability insurance policies. The decision of the Court of Appeals takes away the traditional right of an insurance company to determine for itself whom it will insure and the risks for which it will be liable.

Moreover, this matter is important to individuals or entities who obtain liability insurance coverage and subsequently sell their assets. The decision of the Court of Appeals means that insurance contract benefits are assigned to the asset purchaser as a matter of law even though the insured asset seller contracted with the asset purchaser to exclude the insurance contract from the sale of assets. Even though an insured believes that it has contracted to retain the benefits of the insurance contract to provide funds if it is called upon to indemnify the asset purchaser pursuant to the terms of the asset purchase agreement, it loses those benefits under the decision of the Court of Appeals. The insured's contract is impaired because the asset purchaser does not pay the insured for the value of the insurance coverage transferred by operation of law. This matter also is of interest to any entity that has purchased the assets of another entity, because the decision of the Court of Appeals gives

the asset purchaser insurance contract benefits that heretofore it could not obtain without consent of the insurer.

The correct resolution of this obviously important question will materially affect the insurance industry, not only any insurance company issuing liability insurance, but also anyone purchasing insurance coverage from another entity as well as the purchasers of the assets of the insured. Accordingly, this Court should resolve that issue and the conflict that now exists between the circuits on that issue.

CONCLUSION

For the reasons discussed above, this Court should grant this Petition for Writ of Certiorari and reverse the decision of the Court of Appeals in this matter.

DATED: May 5, 1992.

Respectfully submitted,

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APPENDIX A

FOR PUBLICATION

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

NORTHERN INSURANCE COMPANY OF NEW YORK, *Plaintiff-Appellee-Cross-Appellant,* v. ALLIED MUTUAL INSURANCE COMPANY, *Defendant-Appellant-Cross-Appellee.*	Nos. 90-35579 90-35631 D.C. No. CV-89-768-C OPINION

Appeal from the United States District Court
for the Western District of Washington
John C. Coughenour, District Judge, Presiding

Argued and Submitted
January 7, 1992 – Seattle, Washington

Filed February 7, 1992

Before: Eugene A. Wright, William A. Norris
and Cynthia Holcomb Hall, Circuit Judges.

Opinion By Judge Wright

SUMMARY

Insurance

Affirming in part, reversing in part and remanding a district court judgment, the court of appeals held that although an asset purchase agreement did not include an insurer's liability policy, the insurer nonetheless had a duty to provide the asset purchaser a defense because products liability for presale injuries transferred as a matter of law.

Brown-Forman Corporation bought California Cooler in 1985, two years after the Howards' son was born suffering from fetal alcohol syndrome caused by the mother's consumption of California Coolers during her pregnancy. The asset purchase agreement specified that California Cooler would indemnify Brown-Forman for any product liability claims arising from presale activities and that Brown-Forman would not assume obligation for any such claims. Excluded from the agreement was the assignment of any contract that required consent to assign. After Brown-Forman received the Howards' complaint, it hired a Seattle law firm to provide a defense, and then tendered the defense to Northern Insurance Company. Northern, however, tendered the defense to a second insurer, Allied Mutual. Although Northern insured California Cooler during the last 12 days of the pregnancy, Allied provided coverage for the period starting at about the fourth month of pregnancy and ending 12 days before birth. After the Howards dismissed their

complaint, Northern brought an action seeking contribution from Allied for defense costs. Both parties appealed the district court judgment.

The court agreed that the asset purchase agreement showed that the parties did not intend to transfer Allied's liability policy. However, under both California and Washington law, liability is transferred as a matter of law for claims arising from presale activities, irrespective of any clauses to the contrary in the asset purchase agreement. Thus, the court found that the benefits of Allied's policy, including the right to a defense, transferred by operation of law to Brown-Forman when it purchased substantially all of California Cooler's assets, but only to the extent of presale occurrences. However, the court found that the obligation to provide a defense was one of the two essential promises in the Allied policy. Therefore, the court agreed that California law, rather than Washington law, applied and that under it Allied failed to meet its obligation to provide a defense.

In this case, both Allied and Northern covered California Cooler for the type of loss the Howards alleged. As insurers of a common obligation, each may seek contribution from the other. Although California courts have never answered the precise question of whether an insurer such as Allied is liable to another insurer for pretender defense costs, the question should be resolved by equitable principles and not by the contract between Allied and Brown-Forman. Until Northern is allowed to assert its equitable claim, it is impossible to determine whether it will succeed. On the other hand, Brown-Forman's claims against Allied are not governed by equity,

but by its contract with Allied. As such, the court concluded that the district court erred when it applied provisions in Allied's policy with its insured to prevent Northern from asserting its equitable claims. Thus, on remand, the district court was to refer the matter to arbitration, instructing the arbitrator to consider, under equitable principles. Northern's claims for pre- and post-tender expenses.

COUNSEL

A. Richard Dykstra, Stafford Frey Cooper & Stewart, Seattle, Washington, for the plaintiff-appellee-cross-appellant.

I. Franklin Hunsaker, Bullivant, Houser, Bailey, Pendergrass & Hoffman, Portland, Oregon, for the defendant-appellant-cross-appellee.

OPINION

WRIGHT, Circuit Judge:

This is a dispute between two insurance companies over which one must pay the defense costs of a long since dismissed product liability suit. The two insurers present several issues:

1. When liability is transferred by operation of law under a theory of product-line successor liability, do policy benefits arising from insurance on the underlying risk transfer as well? If so, do these benefits include the right to a defense?

2. When two insurers share a common obligation to provide a defense, can one be obligated for defense costs incurred by the other before the first has been tendered the defense?

3. In this dispute, does California or Washington law apply in determining whether the insurers have met their obligation to provide a defense?

I

The Howards sought damages from the makers of California Cooler after their child was born suffering from fetal alcohol syndrome. They claimed that Dawn Howard's consumption of California Coolers during her pregnancy caused the birth defects. After about two years of pretrial litigation, they voluntarily dismissed the suit.

Brown-Forman Corporation bought California Cooler in July 1985, two years after the birth of the Howards' injured child and two years before the Howards filed suit. The sale was executed through an asset purchase agreement. The agreement specified that (1) California Cooler would indemnify Brown-Forman for any product liability claims arising from California Cooler's presale activities and (2) Brown-Forman would not assume obligation for any such claims. The agreement also excluded from the sale the assignment of any contract that required consent to assign.

When Brown-Forman received the Howards' complaint in November 1987, it hired the Seattle firm of Preston, Thorgrimson to provide a defense, and then tendered the defense to Northern Insurance Company.

Northern sought to have the Lane, Powell firm represent Brown-Forman because Lane, Powell had lower rates. Brown-Forman insisted, however, on retaining Preston, Thorgrimson. Northern acquiesced and Brown-Forman eventually agreed to pay part of the fees.

A few months later, in February 1988, Northern tendered the defense to a second insurer, Allied Mutual. Although Northern had insured California Cooler during the last 12 days of the pregnancy, Allied had provided coverage for the period starting at about the fourth month of pregnancy and ending 12 days before birth. Before Allied responded to Northern's tender, Brown-Forman also tendered the defense to Allied.

Allied accepted the defense under a reservation of rights. It refused, though, to retain Preston, Thorgrimson and instead hired the Betts, Patterson firm. Brown-Forman objected, but eventually agreed to allow Betts, Patterson to participate in the defense with Preston, Thorgrimson.

After the Howards dismissed their complaint, Northern brought this action, seeking contribution from Allied for defense costs. On cross motions for summary judgment, the district court ruled that:

1. Although the asset purchase agreement did not transfer Allied's insurance policy to Brown-Forman, Allied nonetheless had a duty to provide Brown-Forman a defense. Liability for presale injuries transferred to Brown-Forman as a matter of law. The court held that the policy benefits transferred with the liability.

2. California law governed the determination of whether Allied had discharged its obligation to provide a defense by hiring Betts, Patterson.

3. Because of the inherent conflict of interest between Allied and its insured, Allied failed to discharge its obligation by refusing to retain Preston, Thorgrimson.

4. Allied was not liable for defense costs incurred before the defense was tendered to Allied.

5. Allied's contribution to Northern for post-tender costs would be determined based on equitable factors, through mandatory arbitration as specified by California law.

Both parties appeal. A summary of the key dates and events follows.

Insurance Coverage	*Howard Lawsuit*
	January 1983 (Pregnancy begins)
April 4, 1983 (Allied coverage begins)	
September 20, 1983 (Allied coverage ends/ Northern coverage begins)	
	October 2, 1983 (injured child's birth)
July 2, 1985 (asset sale transferring California Cooler to Brown-Forman)	
September 20, 1985 (Northern coverage ends)	

November 1987
(suit filed/
defense tendered to Northern)

February 1988
(Northern tenders to Allied)

March 1988
(Brown-Forman tenders to
Allied)

July 1989
(suit dismissed)

II

A. *The agreement did not assign the insurance.*

Allied argues, and the district court found, that the asset purchase agreement excluded Allied's liability policy from the assets transferred. We agree that the contract as a whole shows that the parties did not intend to transfer the policy.

Although the agreement includes a list of insurance policies transferred to Brown-Forman, it omits any specific reference to the Allied policy. The list does not purport, however, to be complete. In addition, the agreement includes a broad provision that transfers "all of the assets" of California Cooler to Brown-Forman, including "all contract, . . . insurance policies, . . . and other binding contracts." The parties limited this broad language with a clause exempting "Excluded Assets."

Included among the "Excluded Assets" are any contracts that require consent to assign. By its terms, Allied's policy required California Cooler to obtain its consent

before assigning the policy. Arguably, transferring policy *benefits* arising from presale activity is different from transferring the policy itself, and could have been done without Allied's consent. *See, e.g., Greco v. Oregon Mutual Fire Ins. Co.*, 12 Cal. Rptr. 802, 806 (1961). Yet we find little evidence of any intent to transfer these policy benefits. The question then is whether the agreement transferred the policy itself, and we find that given the plain language of the no assignment clause in Allied's policy, it falls within the agreement's "Excluded Assets".

B. *The policy benefits were transferred by operation of law.*

California and Washington, like many other jurisdictions, apply a rule of product-line successor liability. Under this theory, a purchaser of substantially all assets of a firm assumes, with some limitations, the obligation for product liability claims arising from the selling firm's presale activities. Liability is transferred irrespective of any clauses to the contrary in the asset purchase agreement. *See, e.g., Martin v. Abbott Laboratories*, 689 P.2d 368, 384 (Wash. 1984); *Ray v. Alad Corp.*, 560 P.2d 3, 11 (Cal. 1977).

The district court found that the right to indemnity arising from California Cooler's policy transferred together with the potential liability. This right to indemnity followed the liability rather than the policy itself. As a result, even though the parties did not assign Allied's policy in the agreement, the right to indemnity under the policy transferred to Brown-Forman by operation of law.

The right to indemnity is, however, of little importance in this case. The Howards failed to obtain an award and there is no indemnity. The key question in whether the right to a defense also followed the liability. The district court held that it did, relying on *Ocean Accident & Guar. Corp. v. Southwestern Bell Tel. Co.*, 100 F.2d 441 (8th Cir.), *cert. denied*, 306 U.S. 658 (1939).

The court in *Ocean Accident* considered a dispute analogous to the one here. Southwestern Bell bought Kansas City Telephone. After the sale, three employees sued for injuries suffered before the sale. Kansas City's insurer, Ocean Accident, refused to pay, contending that it had not consented to an assignment of rights under the policy for presale injuries. (It had consented to an assignment of rights, but the assignment made clear that it applied prospectively, covering only post-sale injuries. *Id.* at 443.) The court nevertheless held that Ocean Accident had to reimburse Southwestern Bell for the loss, including attorneys' fees. *Id.* at 444-45.

We agree with the *Ocean Accident* court that the rationale for honoring "no assignment" clauses vanishes when liability arises from presale activity. *Id.* at 444. Insurers take account of the nature of the insured when issuing a policy. Risk characteristics of the insured determine whether the insurer will provide coverage, and at what rate. An assignment could alter drastically the insurer's exposure depending on the nature of the new insured. "No assignment" clauses protect against any such unforeseen increase in risk. When the loss occurs before the transfer, however, the characteristics of the successor are of little importance; regardless of any transfer the insurer still covers only the risk it evaluated when it wrote the

policy. *See generally* Larry D. Gaunt & Numan A. Williams, Commercial Liability Underwriting 277-309 (1978) (noting that the inherent hazard of a product is the most important factor in underwriting and discussing other factors to consider including quality control, the consumer market, claims information and warranties, but not the identity of the company).

The *Ocean Accident* court did not limit its holding to the right to indemnity. It held that Southwestern Bell was entitled to all the rights under the policy, including the right to a defense. *Id.* at 445. It rejected the contention that the personal nature of the relationship between Kansas City and Ocean Accident precluded a transfer of the right to a defense. The cooperation clause of the policy protected Ocean Accident from increased costs should Southwestern Bell prove a reluctant partner in the defense. Ocean Accident did not have to provide a defense if Southwestern Bell failed to satisfy its duty to aid in the defense. Hence, Southwestern Bell was entitled both to indemnity and a defense. *Id.*

Allied argues that to the extent that *Ocean Accident* allows a nonconsensual transfer of defense rights, it should not be followed. Allied contends that unlike potential indemnity liability, defense costs are not quantifiable until the suit is complete. It argues that the particular characteristics of the defendant affect the cost of the defense. Substituting a different defendant may alter substantially defense costs. We disagree.

The nature of the risk, rather than the particular characteristics of the defendant, will have the greater effect on defense costs. The extent and character of the

defense will turn on the nature of the product itself and the attributes of the firm that manufactured the product. Aspects of the successor firm could affect the defense, but the shape of the defense will be determined largely by the characteristics of the risk originally insured. Admittedly, defense costs could balloon if the successor firm failed to cooperate in the defense. Inasmuch as the successor firm was not a party to the original policy, the risk of noncooperation arguably increases. Yet, the insurer is protected against this risk because it is freed of its defense obligation if the successor firm does not fulfill its duty to aid in the defense. *See* 14 George J. Couch et al., Couch on Insurance § 51:106 (2d ed. 1985).

In short, we find that the benefits of Allied's policy, including the right to a defense, transferred by operation of law to Brown-Forman when Brown-Forman purchased substantially all of California Cooler's assets. Of course, these benefits extend only to coverage for presale occurrences.

III

The next question is whether Allied fulfilled its duty to provide a defense when it hired Betts, Patterson. Under Washington law, it did; under California law, it did not. California protects insureds by requiring insurers to pay the reasonable costs of independent counsel when a conflict of interest exists between the insured and insurer. Conflicts arise when, as here, the insurer reserves its rights on an issue over which defense counsel exerts some degree of control. *San Diego Navy Fed. Credit Union v. Cumis Ins. Soc'y,* 208 Cal. Rptr. 494 (App. 1984); *see also*

Cal. Civ. Code § 2860 (West Supp. 1992) (codifying, with modifications, the *Cumis* rule).

In diversity actions, this court applies the forum state's choice of law rules. *Klaxon Co. v. Stentor Elec. Mfg. Co.*, 313 U.S. 487, 496 (1941). Washington courts have adopted the Restatement's "most significant relationship" test for resolving choice of law issues in contract disputes. *Potlach No. 1 Federal Credit Union v. Kennedy*, 459 P.2d 32, 34 (Wash. 1969). The Restatement explains that absent an express choice of law by the parties, the law of the state with the most significant relationship to the transaction and the parties governs. Restatement (second) Conflict of Laws § 188 (1971). The contacts courts should consider include:

> (a) the place of contracting,
>
> (b) the place of negotiation of the contract,
>
> (c) the place of performance,
>
> (d) the location of the subject matter of the contract, and
>
> (e) the domicil[e], residence, nationality, place of incorporation and place of business of the parties.

Id. The Restatement directs courts to evaluate these contacts according to their relative importance with respect to each issue. *Id.*

These parties negotiated and contracted in California. The insured and the insurer's agent were located in California. But, the injury occurred in Washington, and the

Howards brought suit there. According to Allied, California lacks any interest in this case because only Washington is interested in enforcing its ethical rules.

The underlying concern is not, however, the enforcement of ethical rules, but rather the protection of the insured when its interests conflict with those of its insurer. *Cumis,* and now section 2860, accomplishes this by requiring insurers to provide independent counsel when a conflict arises. California has a strong interest in protecting its insureds from the risks inherent in a defense provided under a reservation of rights. *See Cumis,* 208 Cal. Rptr. 494, 498 (App. 1984). Applying California law does not harm Washington's interest. Attorneys practicing in Washington still must abide by local ethical rules and may be sanctioned for failing to do so.

Allied argues further that even if California law applies, the fulfillment of the obligation to provide a defense is a mere detail of performance, subject to the law of the place of performance. Restatement (Second) Conflict of Laws § 206 (1971). Whether something constitutes a detail of performance or a substantial right is more a matter of degree than kind. Typical examples of details of performance include the exact time and place of payment and the currency allowed for payment. Substantial rights, on the other hand, include the amount to be paid and whether payment may be withheld under a moratorium statute. *Id.*

Allied relies on *Raymond v. Monsanto Co.,* 329 F. Supp. 247 (D.N.H. 1971) and *Gates Formed Fibre Products v. Plastic Vac, Inc.,* 687 F. Supp. 688 (D. Me. 1988). Each held that the location of the insured risk rather than the place of

contracting determined the law to be applied. But in each case, the state of the insured risk had an interest in having its own law applied. *See* 329 F. Supp. at 249; 687 F. Supp. at 691. Washington has no specific interest in having its more lenient standard applied here. California, on the other hand, has a strong interest in seeing its law applied to protect both an insured domiciled in California and the substantive rights of parties to a contract negotiated and executed there.

The obligation to provide a defense is one of the two essential promises in the Allied policy. Given the central role this obligation plays in the contract, we find that rules such as the *Cumis* rule, which play a defining role in determining the scope of this obligation, relate to a substantial right rather than a mere detail of performance. We agree with the district court that California law applies and that under California law Allied failed to meet its obligation to provide a defense.

IV

Allied's policy has a provision precluding reimbursement for defense costs voluntarily incurred before tender. California courts have consistently honored these provisions, and will not require insurers to pay for voluntarily incurred pretender costs. *See, e.g., Gribaldo, Jacobs, Jones & Assoc. v. Agrippina Versicherunges A.G.*, 3 Cal. 3d 434, 476 P.2d 406, 415, 91 Cal. Rptr. 6 (1970).

Northern argues, though, that a recent California case leaves open the possibility that insurers may be liable for pretender costs. In *Fiorito v. Superior Court*, 226 Cal. App. 3d 433, 277 Cal. Rptr. 27 (1990), the court

reversed the sustaining of a demurrer, explaining that the insured could be entitled to pre-tender defense costs. 277 Cal. Rptr. at 31. Yet the court's decision rested on the possibility that the pre-tender costs were incurred involuntarily. *Id.* In the court's view, if the insured was forced to incur costs before it had time to tender the defense, those costs could be considered involuntarily incurred. The court left intact the normal rule against reimbursement for voluntarily incurred pre-tender costs.

In contrast to *Fiorito,* Northern's costs were incurred voluntarily. This was not an instance in which the defense had to begin before the insured had time to identify the insurer and then tender the defense. In fact, Brown-Forman did just that, except it identified and tendered to Northern rather than Allied.

Allied may nevertheless be liable for expenses Northern incurred before the defense was tendered to Allied. The limitation on reimbursement for voluntarily incurred pre-tender expenses is contractual. It arises solely from the policy itself rather than any general rule of law. In this case, it binds Allied and its insured, but it does not nor can it bind others. Northern was not a party to the original policy; its only relation to Allied is as a later insurer of the same risk. Basic principles of contract law prevent us from applying the contractual limitation against pre-tender expenses to Northern, a stranger to the contract.

Under California law, it is well established that the reciprocal rights of several insurers covering the same risk arise from principles of equity rather than contract. *American Auto. Ins. Co. v. Seaboard Surety Co.,* 155 Cal.

App. 2d 192, 318 P.2d 84, 86 (1957). California follows the general rule that an insurer that discharges a common obligation of another insurer may seek contribution from the second insurer. *CNA Casualty of Cal. v. Seaboard Surety Co.*, 176 Cal. App. 3d 598, 222 Cal. Rptr. 276, 288, *rev. denied*, (1986). The insurers' "respective obligations flow from equitable principles designed to accomplish ultimate justice in the bearing of a specific burden." *American Auto. Ins.*, 318 P.2d at 86. No specific rule governs this area of the law. Courts should consider the nature of the claim, the relation of the insured to the insurers, the particulars of each policy and any other equitable considerations. *Id.*

In this case, both Northern and Allied covered California Cooler for the type of loss the Howards alleged. Because the injury occurred over time, the consecutive coverage each insurer provided potentially covered the same injury. As insurers of a common obligation, each may seek contribution from the other.

Although California courts have never answered the precise question of whether an insurer such as Allied is liable to another insurer for pre-tender defense costs, the question should be resolved by equitable principles and not by the contract between Allied and Brown-Forman. Northern may not succeed in its claim; equitable principles may weigh against reimbursement. For example, the prejudice Allied suffered from the delay in tender may be enough to prevent recovery. Until Northern is allowed to assert its equitable claim, it is impossible to determine whether Northern will succeed.

On the other hand, Brown-Forman's claims against Allied are not governed by equity, but by its contract with Allied. In particular, Allied may not be held liable for that portion of Preston, Thorgrimson's fee Brown-Forman paid. These payments, unlike the payments made by Northern, fall within the contractual provisions in Brown-Forman's policy with Allied precluding reimbursement for pre-tender costs.

We conclude that the district court erred when it applied provisions in Allied's policy with its insured to prevent Northern from asserting its equitable claim. California law requires Northern to resolve its claims through mandatory arbitration, unless the policies provide otherwise. Cal. Civ. Code § 2860(c). On remand, the district court should refer this matter to arbitration as provided in the statute, instructing the arbitrator to consider, under equitable principles, Northern's claims for pre- and post-tender expenses.

The parties will bear their own costs on this appeal.

AFFIRMED IN PART, REVERSED IN PART AND REMANDED.

APPENDIX B

UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF WASHINGTON
AT SEATTLE

NORTHERN INSURANCE CO. OF NEW YORK,	)	
Plaintiff,	)	NO. C89-768C
vs.	)	ORDER ON CROSS
ALLIED MUTUAL INSURANCE COMPANY,	)	MOTIONS FOR SUMMARY JUDGMENT
Defendant.	)	

I. BACKGROUND

Brittany Howard was born on October 2, 1983, with fetal alcohol syndrome ("FAS"). Mark Howard sued several manufacturers of alcoholic beverages, including California Cooler Co., Brown-Forman Corp., CCI Liquidation Corp., and California Cooler, Inc., for damages to Brittany (the *Howard* suit). The complaint alleged that the defendants knew or should have known of the link between their products and FAS. Therefore, they were negligent or strictly liable for their failure to warn consumers.

Defendant Allied Mutual Insurance Co. ("Allied") insured California Cooler, Inc. ("CCI") from April 4 through September 20, 1983. Plaintiff Northern Insurance Co. ("Northern") insured CCI from September 20, 1983 to September 20, 1986.

In July, 1985, Brown-Forman Corp. purchased the assets of CCI. After the purchase, CCI became CCI Liquidation Corp., and ceased manufacturing California Coolers. Brown-Forman created an unincorporated division, California Cooler Co. ("CCC"), to manufacture California Coolers. Jojole Corp. became the new California Cooler, Inc. ("new CCI"), which does not manufacture coolers.

Through Brown-Forman, the new CCI tendered and Northern accepted defense of the *Howard* suit, subject to a reservation of rights. Northern retained the law firm of Preston, Thorgrimson, Ellis and Holman ("Preston"). In March, 1988, Brown-Forman tendered defense of the suit to Allied. Allied refused to retain and pay for Preston, and instead retained Betts, Patterson & Mines ("Betts") to provide a defense for CCI. Allied reserved all of its rights.

In May, 1989, Northern filed this action for declaratory judgment and contribution against Allied. Northern moves for partial summary judgment declaring that (1) Allied had a duty to defend CCI and Brown-Forman in the *Howard* suit; (2) Northern has an equitable right to contribution from Allied for defense costs of the *Howard* suit; and (3) Allied did not discharge its duty to defend by retaining Betts. Allied moves for partial summary judgment declaring that (1) Allied had no duty to defend the new CCI, and consequently owes no contribution to Northern; or in the alternative (2) Northern has no right to contribution for costs it incurred before defense was tendered to Allied.

II. DUTY TO DEFEND

This court previously held that California law governs the insurance contract between Allied and CCI. Under California law, the duty to defend is determined on the basis of any potential liability arising from facts available to the insurer when defense is tendered. *CNA Casualty of California v. Seaboard Surety Co.*, 222 Cal. Rptr. 276, 278-79 (Cal. Ct. App. 1986). The duty to defend is so broad that if the complaint contains language creating the potential for liability, the insurer must defend even if it has independent knowledge of facts which establish non-coverage. *Id.* at 279. Any doubt regarding the duty to defend is resolved in favor of the insured. *St. Paul Fire & Marine Ins. Co. v. Sears, Roebuck & Co.*, 603 F.2d 780, 786 (9th Cir. 1979).

A. Duty to CCI Liquidation.

The *Howard* amended complaint and Brown-Forman's tender to Allied triggered Allied's duty to defend CCI Liquidation Corp. First, damage to a fetus during insurance coverage which results in physical injury manifested at birth is covered under the policy, even though birth occurred after the policy expired. *Endo Laboratories, Inc. v. Hartford Ins. Group*, 747 F.2d 1264, 1268 (9th Cir. 1984).

Second, the complaint alleged that CCI caused actual bodily injury to Brittany during the coverage period. The Ninth Circuit applies the exposure rule, which holds that bodily injury occurs when an exposure causing tissue damage takes place. *Hancock Laboratories, Inc. v. Admiral*

Ins. Co., 777 F.2d 520, 523 (9th Cir. 1985). Since exposure, i.e., California Cooler consumption, occurred during pregnancy, bodily injury is alleged during Allied's coverage.

Third, the complaint named as defendants CCI and CCI Liquidation Corp., the new name of the Allied insured. Allied was put on notice that its insured, in whatever form, was being sued.

Fourth, the suit was tendered to Allied by Brown-Forman, owner of CCI Liquidation. Allied cites no authority for its position that the owner of an insured company cannot tender to the insurer on behalf of the insured.

Finally, even though the relationships between CCI, the new CCI, Brown-Forman, and CCI Liquidation raise coverage questions, Allied's independent knowledge of those relationships cannot vitiate its duty to defend its named insured, the former CCI. *CNA Casualty of California v. Seaboard Surety Co.*, 222 Cal. Rptr. 276, 279 (Cal. Ct. App. 1986)[.] Allied had a duty to defend CCI, now CCI Liquidation.

B. Duty to the New CCI.

Northern asserts that Allied had a duty to defend the new CCI. Even under the broad duty to defend, Northern has not established why Allied should defend the new CCI, an entity related to the named insured by title only. Allied had no duty to defend the new CCI.

C. Duty to Brown-Forman: Assignment of the Insurance Contract and Rights Therein.

Northern asserts that Allied had a duty to defend Brown-Forman because the Asset Purchase Agreement ("APA") contained broad language transferring CCI's rights in insurance policies to Brown-Forman. Despite this alleged transfer, the Agreement explicitly excluded assumption by Brown-Forman of liabilities or claims relating to pre-sale CCI operations. APA § 12.1. CCI agreed to indemnify Brown-Forman against such liabilities. APA § 3.2.

Liability policies cannot be assigned without the consent of the insurer. 6B Appleman, *Insurance Law and Practice* § 4269 (1979). The Allied policy stated that, absent Allied's consent, assignments were not binding. Since Allied never consented to an assignment to Brown-Forman, no effective assignment occurred.

In support of assignment, Northern relies on *Ocean Accident & Guarantee Corp. v. Southwestern Bell Telephone Co.*, 100 F.2d 441 (8th Cir. 1939). *Ocean* holds that after a liability-causing event occurs, the right to protection against liability is assignable with or without the insurer's consent. *Id.* at 444, 447. This exception exists because after a loss, an insurer becomes a debtor, and the insured may transfer its rights to the amounts like any other debt. *Id.* at 445-46.

Ocean does not hold that a right to a defense is assignable where the assignee has not assumed the liabilities of the original insured. The right to a defense is not similar to a chose in action. Allied had no duty to defend Brown-Forman.

III. DISCHARGE OF THE DUTY TO DEFEND AND RIGHT TO CONTRIBUTION

A. Choice of Law.

Allied asserts that Washington law governs the issue of whether Allied discharged its duty to defend. Allied claims discharge is a "detail of performance," and therefore governed by the local law of the place of performance. Restatement (Second) of Conflicts of Law § 206 (1971). However, "details of performance" do not include matters which substantially affect the nature and extent of obligations imposed by contract. Restatement (Second) of Conflicts of Law § 206 comment b (1971). Discharge of Allied's duty to defend is not a detail of performance because it goes directly to Allied's obligations under the policy. California law applies.

B. Conflict of Interest.

Under California law, an insurer must pay for an insured's independent counsel if a conflict of interest exists. Cal. Civ. Code § 2860. A conflict of interest exists where liability is based on the nature of the insured's conduct, which as developed at trial would affect the determination of coverage. *McGee v. Superior Court of Cal.*, 221 Cal. Rptr. 421, 423 (Cal. Ct. App. 1985); *San Diego Navy Federal Credit Union v. Cumis Insurance Society, Inc.*, 208 Cal. Rptr. 494, 498 (Cal. Ct. App. 1984).

The basis of the *Howard* action was CCI's failure to warn consumers about FAS. Under Washington law, a manufacturer's knowledge is an element of negligent failure to warn. *Lockwood v. A C & S, Inc.*, 44 Wn. App.

330, 338 (1986). One ground upon which Allied reserved its rights was whether CCI expected injury to Brittany Howard. Knowledge, an element of the *Howard* claim, and expectation of injury, a basis for coverage exclusion, are similar states of mind. A conflict of interest existed because Allied had an interest in establishing that the insured had knowledge of potential fetal injury. Allied was obligated to contribute to payment to Preston, CCI's independent counsel.

C. Amount of Contribution.

1. Pre-tender costs.

The *Howard* action was filed in November, 1987. Tender was not made to Allied until March, 1988. Under California law, an insured may incur defense costs without the insurer's permission only after the insured has requested and the insurer has denied a defense. *Gribaldo, Jacobs, Jones & Associates v. Agrippina Versicherunges A.G.*, 91 Cal. Rptr. 6, 15 (Cal. 1970). Northern cites no relevant authority to support its contention that a different rule applies between insurers. Allied is not liable for costs Preston incurred before Allied was tendered the defense.

2. Post-Tender Equitable Contribution.

Under California law, defense costs between insurers are apportioned on equitable considerations. *CNA Casualty of California v. Seaboard Surety Co.*, 222 Cal. Rptr. at 288. Contribution to Northern should be determined on

equitable factors and, unless the policies provide otherwise, through mandatory arbitration under Cal. Civ. Code § 2860(c).

IV. CONCLUSION

Northern's motion for partial summary judgment on the grounds that Allied had a duty to defend CCI and must contribute to defense costs of the *Howard* suit is GRANTED. Northern's motion for partial summary judgment on the ground that Allied had a duty to defend Brown-Forman is DENIED.

Allied's motion for partial summary judgment on the grounds that Allied had no duty to defend the new CCI or Brown-Forman and that Allied is not liable for pretender defense costs is GRANTED. Allied's motion for partial summary judgment on the ground that Allied owes no contribution to Northern is DENIED.

The parties shall submit their claims to arbitration pursuant to Cal. Civ. Code § 2860(c), unless the policies provide otherwise.

The Clerk of this Court is directed to send uncertified copies of this Order to all counsel of record.

DATED this 4 day of April, 1990.

/s/ John C. Coughenour
John C. Coughenour
United States District Judge

APPENDIX C

UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF WASHINGTON
AT SEATTLE

NORTHERN INSURANCE COMPANY OF NEW YORK, Plaintiff, v. ALLIED MUTUAL INSURANCE COMPANY, Defendant.	NO. C89-768C ORDER GRANTING MOTION FOR RECONSIDERATION

I. Background

Northern Insurance Company of New York (Northern) and Allied Mutual Insurance Company (Allied) dispute whether Allied is obligated to contribute to Northern's defense of California Cooler and related corporate entities in a products liability action against California Cooler. In the underlying action, the plaintiff alleged that beverages manufactured by California Cooler caused FAS (fetal alcohol syndrome) in his child.

Both Allied and Northern insured California Cooler during the time in which the claim arose. After Allied's policy had expired but while Northern's policy was still in effect, Brown-Forman purchased all but the corporate shell of California Cooler. Brown-Forman tendered the defense to Northern, which retained the Preston law firm. Brown-Forman tendered defense of the suit to Allied also. Allied retained Betts, Patterson & Mines, with full

reservation of rights. Northern brought this action for contribution by Allied to the fees accrued by the Preston firm. Upon cross-motions for summary judgment, this court held that Allied had a duty to defend the corporate shell of California Cooler, but had no duty to defend Brown-Forman.

II. Reconsideration

Northern asserts that the court erroneously ruled that there was no valid transfer of the insurance policy. The purchase and sale agreement, construed as a whole, does not evince the alleged intent of the seller and buyer to assign the Allied policy. The motion for reconsideration as to this issue is **DENIED.**

However, it does not follow that Allied had no obligation to defend the liability which arose under its policy unless that claim was brought against the named insured. Northern correctly asserts that, because liability for a claim against California Cooler was transferred, the insurance covering that claim was also transferred. The motion for reconsideration as to this issue is **GRANTED.**

Northern relies on *Ocean Accident & Guarantee Corp. v. Southwestern Bell Telephone Co.*, 100 F.2d 441 (8th Cir. 1939), for its assertion that, because Brown-Forman was potentially liable as a product line successor, its right to a defense arose at the same time as the cause of action, prior to the transfer of assets. *Ocean Accident* states the accepted rule: where loss occurs before an invalid assignment, the insurer must pay that loss to the party to whom the policy was invalidly assigned.

The rationale for the rule is that the consent clause in insurance contracts protects the insurer against unknowingly bearing an increased risk. *See id.* at 466. *See also University of Judaism v. Transamerica Insurance Co.*, 61 Cal. App. 3d 937, 132 Cal. Rptr. 907, 909 (Cal. Ct. App. 1976); *National American Insurance Co. v. Jamison Agency, Inc.*, 501 F.2d 1125 (8th Cir. 1974); *Citicorp Industrial Credit, Inc. v. Federal Insurance Co.*, 672 F. Supp. 1105 (N.D. Ill. 1987). No increased risk to the insurer exists where the loss occurs prior to the assignment. *Id.* at 1106-07. This holds true whether or not the loss is reduced to judgment prior to the transfer of the policy. *Ocean Accident*, 100 F.2d at 446. The duty to defend, which is less easily avoided than the duty to indemnify, falls within this reasoning. *Cf. Ocean Accident*, 100 F.2d at 447-48 (disputing proper amount of attorneys fees, but not insurer's underlying obligation to pay those fees).

Analytically, the right to indemnity travels with the liability that was insured against, not with the policy itself.[1] Although the issue in *Ocean Accident* concerned an invalid assignment due to lack of consent, the reasoning applies with equal force to the situation where there was no assignment. Because the claim against Brown-Forman arose prior to the transfer of assets, Allied was obligated to contribute to the defense of the claim.

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[1] "The principle on which the courts hold that an assignment of a right under a policy prohibiting assignment may be made is that such an assignment is not the assignment of the policy itself (because the parties have contracted otherwise), but it is the assignment of a claim, or debt, or chose in action." *Ocean Accident*, 100 F.2d at 446.

The result of this ruling on Northern's motion for reconsideration is a strong equitable claim by Northern in mandatory arbitration required under California law. This court has already held that Allied's duty to California Cooler was not fully discharged by its retention of Betts, Patterson & Mines, due to a potential conflict of interest between Allied and its insured.

The Clerk of the Court shall send uncertified copies of this order to all counsel of record.

DATED this 26 day of June, 1990.

/s/ John C. Coughenour
John C. Coughenour
United States District Judge

APPENDIX D

California Civil Code § 2860 provides as follows:

§ 2860. Conflict of interest; duty to provide independent counsel; waiver; qualifications of independent counsel; fees; disclosure of information

(a) If the provisions of a policy of insurance impose a duty to defend upon an insurer and a conflict of interest arises which creates a duty on the part of the insurer to provide independent counsel to the insured, the insurer shall provide independent counsel to represent the insured unless, at the time the insured is informed that a possible conflict may arise or does exist, the insured expressly waives, in writing, the right to independent counsel. An insurance contract may contain a provision which sets forth the method of selecting that counsel consistent with this section.

(b) For purposes of this section, a conflict of interest does not exist as to allegations or facts in the litigation for which the insurer denies coverage; however, when an insurer reserves its rights on a given issue and the outcome of that coverage issue can be controlled by counsel first retained by the insurer for the defense of the claim, a conflict of interest may exist. No conflict of interest shall be deemed to exist as to allegations of punitive damages or be deemed to exist solely because an insured is sued for an amount in excess of the insurance policy limits.

(c) When the insured has selected independent counsel to represent him or her, the insurer may exercise its right to require that the counsel selected by the insured possess certain minimum qualifications which

may include that the selected counsel have (1) at least five years of civil litigation practice which includes substantial defense experience in the subject at issue in the litigation, and (2) errors and omissions coverage. The insurer's obligation to pay fees to the independent counsel selected by the insured is limited to the rates which are actually paid by the insurer to attorneys retained by it in the ordinary course of business in the defense of similar actions in the community where the claim arose or is being defended. This subdivision does not invalidate other different or additional policy provisions pertaining to attorney's fees or providing for methods of settlement of disputes concerning those fees. Any dispute concerning attorney's fees not resolved by these methods shall be resolved by final and binding arbitration by a single neutral arbitrator selected by the parties to the dispute.

(d) When independent counsel has been selected by the insured, it shall be the duty of that counsel and the insured to disclose to the insurer all information concerning the action except privileged materials relevant to coverage disputes, and timely to inform and consult with the insurer on all matters relating to the action. Any claim of privilege asserted is subject to in camera review in the appropriate law and motion department of the superior court. Any information disclosed by the insured or by independent counsel is not a waiver of the privilege as to any other party.

(e) The insured may waive its right to select independent counsel by signing the following statement: "I have been advised and informed of my right to select independent counsel to represent me in this lawsuit. I have considered this matter fully and freely waive my

right to select independent counsel at this time. I authorize my insurer to select a defense attorney to represent me in this lawsuit."

(f) Where the insured selects independent counsel pursuant to the provisions of this section, both the counsel provided by the insurer and independent counsel selected by the insured shall be allowed to participate in all aspects of the litigation. Counsel shall cooperate fully in the exchange of information that is consistent with each counsel's ethical and legal obligation to the insured. Nothing in this section shall relieve the insured of his or her duty to cooperate with the insurer under the terms of the insurance contract.

APPENDIX E

General Rule 2(e) of the Rules of the United States District Court for the Western District of Washington provides as follows:

(e) Disbarment and Discipline.

(1) The members of the bar of this Court shall be governed by and shall observe the Canons of Professional Ethics, as promulgated by the Washington State Supreme Court and in effect at the time these rules are adopted, together with any amendments of or additions to such Canons of Professional Ethics, unless such amendments or additions are specifically disapproved by the Court.

APPENDIX F

The Fourteenth Amendment to the Constitution of the United States provides, in relevant part:

Section 1. All persons born or naturalized in the United States, and subject to the jurisdiction thereof, are citizens of the United States and of the State wherein they reside. No State shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States; nor shall any State deprive any person of life, liberty, or property, without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws.